

SEC Examinations and the Risk Assessment Process

***2007 CCO Outreach Regional
Seminars***

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Population

- Number of SEC registered investment advisers and assets under management as of 9/30/06:
 - 10,662
 - \$32.3 trillion
- Number of registered investment company complexes as of 9/30/06:
 - 933
- Number of investment adviser and investment company examinations conducted during fiscal year 2006 (10/1/05 – 9/30/06):
 - 1,346 IA exams
 - 308 IC exams

Examination Objectives

Examiners seek to determine whether the firm is:

- conducting its activities in accordance with the federal securities laws and rules adopted under these laws;
- adhering to the disclosures it has made to the SEC and investors; and
- Implementing and following a supervisory system and/or compliance policies and procedures that are reasonably designed to ensure that the firm's operations are in compliance with the law.

Types of Examinations

- Reasons advisers are generally selected for inspection:
 - Routine examinations
 - Cause examinations
 - Risk targeted examination sweeps

Risk Assessment Activities

- Risk assessment:
 - Form ADV filing information
 - Examination

Risk Assessment Activities

- Factors that may affect Form ADV risk rating:
 - Disciplinary history
 - Industry affiliations
 - Assets under management
 - Compensation arrangements
 - Number and types of clients

Risk Assessment Activities

- Factors that may affect examination-based risk rating:
 - Compliance culture
 - Effectiveness of compliance program
 - Seriousness and volume of deficiencies noted

High Risk Population

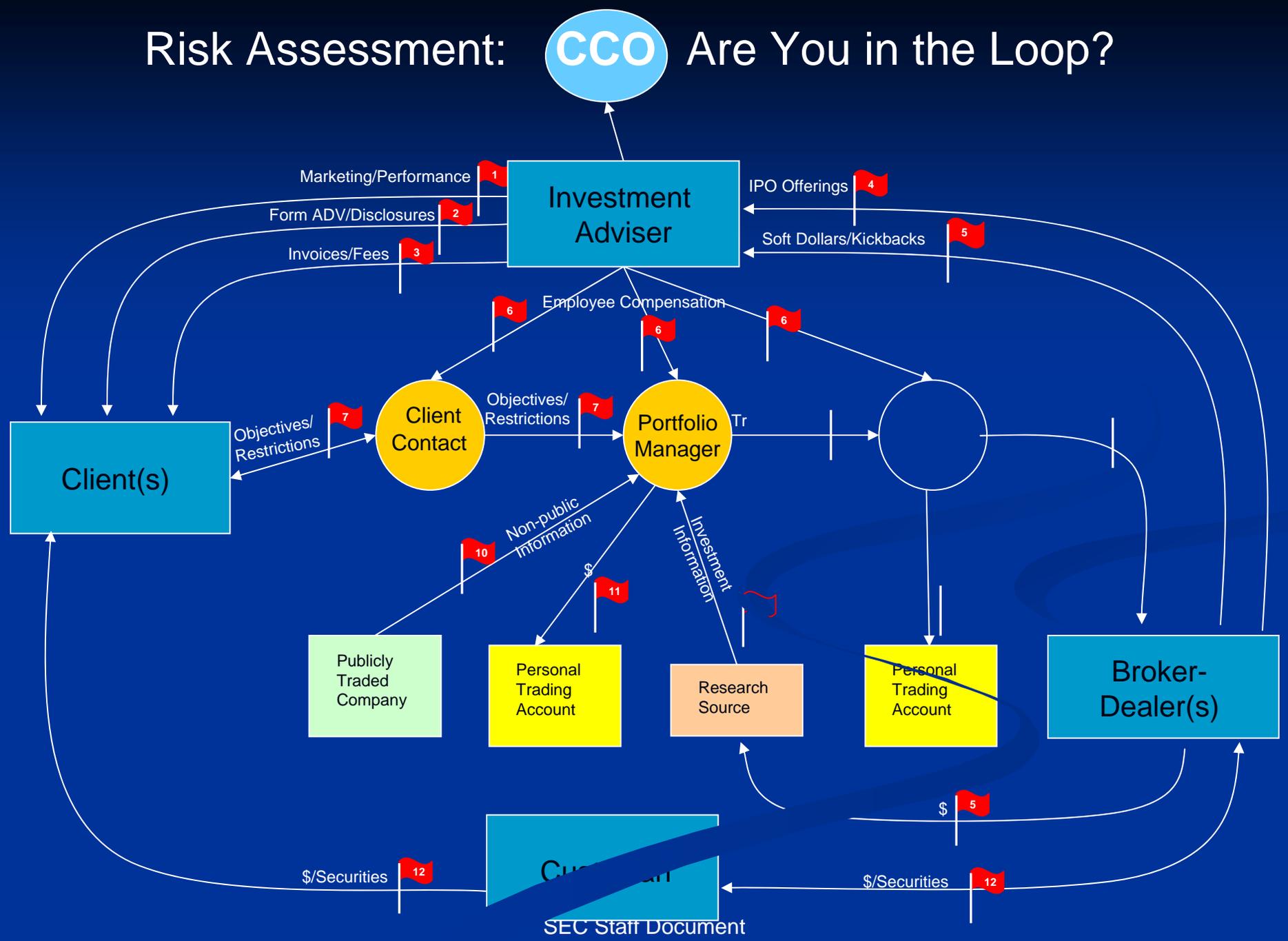
- High risk advisers are placed on a 3-year exam cycle:
 - Advisers rated high risk based on Form ADV rating
 - Advisers rated high risk based on examination

***Examination-Based
Risk
Assessment***

Identifying Risk Areas

- How does the business operate?
 - Flow of information
 - Flow of funds/securities
- Where are the risks?
- How are risks mitigated?
 - What controls are in place?
 - What level of supervision exists?

Risk Assessment: CCO Are You in the Loop?



Risk Inventory Guide*

This chart is intended to visually guide you through some of the risks that may be present as part of an adviser's everyday operations. As a CCO responsible for your firm's compliance, you should determine what risks are present and how they might affect your firm and its operations, assess whether the controls in place manage or mitigate these risks are adequate, and make or recommend modifications to the compliance policies and procedures as necessary. You are not expected to personally perform all compliance-related activities. Rather, you "administer" or manage the compliance program by determining whether controls are necessary and what reviews and tests should be performed, when and by whom, and ensuring that business persons are involved in creating and complying with the established procedures. In essence, you determine "how much is enough."

	Marketing/Performance: ▪ Inaccurate performance calculations ▪ Overstated performance ▪ Guarantees of profit ▪ Unsubstantiated claims ▪ Misrepresentation of services offered ▪ Use of unapproved marketing materials ▪ Misrepresentation about advisory firm and principals
	Form ADV/Disclosures: ▪ Failure to provide Form ADV ▪ Inaccurate, omitted, or unclear disclosures ▪ Out of date disclosures ▪ Misrepresentation of services offered ▪ Failure to disclose potential conflicts of interest ▪ Inaccurate account statements ▪ Overstating account values
	Invoices/Fees: ▪ Non-"research" products obtained without disclosure ▪ Incorrect fee calculation ▪ Use of inflated asset values ▪ Direct debit of fees from custodial account ▪ Prohibited fees
	IPO Offerings: ▪ Directing trades to brokers that provide IPO offerings ▪ Placement of IPO allocations in adviser's proprietary or employees' personal accounts
	Soft Dollars/Kickbacks: ▪ Research and/or sources of research outside safe harbor ▪ Inadequate due diligence on research product ▪ Broker does not pay research source directly ▪ Inaccurate or misleading research obtained ▪ Research obtained is not current ▪ Mixed-use items not appropriately allocated
	Compensation: ▪ Incentive-based compensation leads to inappropriate recommendations or investments

	Objectives/Restrictions: ▪ Objectives not kept current ▪ Objectives miscommunicated or not clearly understood ▪ Adviser influences client to accept higher risk than desired ▪ Failure to reconcile information communicated to portfolio manager and strategy implemented ▪ Restrictions not monitored
	Trade Ticket: Preferential trade allocation ▪ Side by side management conflict ▪ Investments outside client objectives or restrictions ▪ Failure to include required information on trade ticket ▪ Inappropriate allocation on partial fills
	Trade Execution: ▪ Failure to seek to obtain best execution ▪ Favoring broker based on research or referrals received ▪ Post-trade allocation instructions ▪ Principal or cross trades without required disclosure/consent ▪ Errors/correction not identified and resolved in client's best interest
	Non-public Information: ▪ Non public information obtained during analysis phase ▪ Use of non-public information for personal gain/loss avoidance ▪ Use of client trading to manipulate price of publicly traded stock
	Personal and Proprietary Trading Account: ▪ Portfolio manager utilizes knowledge of upcoming trades for gain/loss avoidance in personal account ▪ Trader uses knowledge of market and current or upcoming trades to manipulate prices or for gain/loss avoidance
	Money/Securities to/from Broker/Custodian: ▪ Funds or securities sent to the adviser or employees instead of the custodian ▪ Theft

Common Review Areas

- Compliance programs
- Portfolio management
- Brokerage arrangements and execution
- Personal trading/code of ethics
- Pricing of client portfolios
- Performance advertising and marketing
- Information processing, reporting, & protection
- Safety of clients' funds and assets¹⁰

Focus of Discussion

- Topics selected for discussion based on CCO input:
 - Books and records and disclosures and filings
 - Brokerage arrangements, best execution, trade allocation, and soft dollars
 - Portfolio management
 - Marketing, performance advertising, and distribution

Focus of Discussion

- For each topic, we will discuss:
 - Common requests
 - Analyses performed/forensic tests
 - Common deficiencies
 - Good controls/factors to consider